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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 44

JOHN V. DOBSON,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

No. 45

E. W. DOBSON,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

No. 46

ESTATE OF JAMES N. COLLINS, DECEASED, FIRST NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, EXECUTOR,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

No. 47

H. J. HARWICK,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

The briefs submitted in this case are in direct conflict upon a fundamental question of the greatest importance in the basic tax law of the United States. That question is:

May Congress, by resorting to a method of annual tax accounting, transform a return of invested capital, not taxable under the Sixteenth Amendment, into income which is taxable?

It is undisputed that the taxpayers in this case invested their capital in stock of the National City Bank; that they realized a partial recovery of that capital through resale of the stock; and that the payments made to them in 1939, which are now in question, represented a return of a part of their purchase money in rescission of the purchase. It is not disputed that this recovery in 1939 was still partial and incomplete, and that as a matter of economic reality and hard fact the taxpayers have not yet recovered their capital investment, and not only have gained nothing but are still out of pocket on the transaction. It is the contention of the Government that Congress, by requiring an accounting in the year of the resale of the stock, can change the nature of the later recovery of invested capital so that it becomes taxable income; and that Congress has done so. It is the contention of the taxpayers that Congress has no power either to tax a return of invested capital or to create taxable income by accounting devices; and that Congress has not done so. Upon this fundamental issue, we believe that the case must be decided.

The case for the taxpayers of course rests upon *Eisner vs. Macomber* (1920), 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521; *Bowers vs. Kerbaugh-Empire Co.* (1926), 271 U. S. 170, 46 Sup. Ct. 449, 70 L. Ed. 886; *Doyle vs. Mitchell* (1918),

247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054, and other cases (listed at page 15 of our original Brief) holding that where capital has been invested there can be no income arising out of any reimbursement until that capital has first been restored in full. This apparently is not disputed by the Government. Instead, it is contended that Congress, or the Treasury by Regulations, may set up an accounting procedure by which that capital is deemed to be restored in full when it has not in fact been restored, so that there is thenceforth a "basis of zero for determining gain or loss" (Br. 7) as to the reimbursement. It is the admitted fact that in reality the capital was not restored, and has not yet been restored; but by a fiction it is to be called restored, and upon that fiction there is founded a "basis" for treating a partial restoration as income.

In support of this position, the Government advances various arguments, as follows:

1. The contention that capital gains and losses must be computed on the basis of an annual accounting for each single taxable year.

The Government argues that "Gain or loss is properly ascertained on the basis of a fixed annual accounting period, and income computed annually as the net result of all transactions within the year is properly taxable although there may have been a loss on the overall transaction" (Br. 18), and seeks to apply this proposition to a transaction involving a restoration of invested capital. In support of this argument, reliance is placed upon *Burnet vs. Sanford & Brooks Co.* (1931), 282 U. S. 359, 51 Sup. Ct. 150, 75 L. Ed. 383, where the single-year accounting theory was held to be properly applied to operating expenditures in the performance of a dredging contract, followed by recovery of additional compensation under the contract. The case turns

upon the following language of the Court, at page 363:

> "The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. *They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income.* See *Doyle vs. Mitchell Brothers Co., supra*, page 185 of 247 U. S., 38 Sup. Ct. 467." (Italics supplied.)

The Government interprets the italicized words as meaning merely that if these had been capital expenditures they would properly have been added to basis when made rather than being deducted as a business expense (Br. 19). But this interpretation is not borne out by the record in the case. The decision reversed *Sanford & Brooks Co. vs. Commissioner of Internal Revenue* (C. C. A. 4th Cir., 1929), 35 F. (2d) 312, in which Judge Parker, in holding that the recovery involved was not income, had treated it as a reimbursement of capital outlay, and had said (at page 313):

> "It is said, however, that each year must be treated as a unit for income tax purposes, and that for this purpose we must view the expenditures and collections of each year entirely apart from those of other years. It is undoubtedly true that the year is the unit in income taxation and that income received or accrued within a given year must be reported as of that year; but it by no means follows that the events of other years may not be considered along with a particular item of alleged income in determining whether it constitutes taxable income or mere reimbursement of loss."

It seems clear that the italicized language quoted above was directed to this position of Judge Parker, and that it was written in response to a similar contention in the brief of

the taxpayer filed in the case (Respondent's Brief in *Burnet vs. Sanford & Brooks Co.* (1931), 282 U. S. 359, 51 Sup. Ct. 150, 75 L. Ed. 383, at pages 5-11. See also Brief of *Amici Curiae,* at pages 6-9). It was, as a matter of fact, an adoption of the position taken at that season by the Government, as set forth in its petition for certiorari:

> "The case of *Bowers vs. Kerbaugh-Empire Co.*, 271 U. S. 170, relied upon by the Circuit Court of Appeals, is distinguishable on the facts. In the instant case there was a transaction arising out of the operation of a business where compensation was collected for work performed in earlier years, the expenditures made in performing the work having been properly deducted in those years. In the *Kerbaugh-Empire Co. case* the whole transaction was a capital transaction."
>
> (Petition for Writ of Certiorari, in *Burnet vs. Sanford & Brooks Co., supra,* at page 17.)

To the same effect is the Government's own interpretation of the case after it was decided, found in G. C. M. 22163, 1940-2 C. B. 76, at page 79:

> "Under the principle of the Supreme Court's decision in the Sanford & Brooks Co. case, *supra,* items of expense incurred in carrying on a trade or business do not represent capital investment, the cost of which, if converted, must first be restored before there is a capital gain taxable as income,"

and likewise the interpretation of the Circuit Court of Appeals for the Fourth Circuit in *Commissioner of Internal Revenue vs. Norfolk Southern R. Co.* (C. C. A. 4th Cir., 1933), 63 F. (2d) 304, at page 306:

> "In *Burnet vs. Sanford & Brooks Co.,* the Supreme Court was dealing with a sum received by a contractor in a particular year, as a result of litigation, to recompense it for a loss sustained in an earlier year. The amount so received was held income for the year in which received on the principle that the whole business was a continuing one engaged in for profit; and the distinction was clearly made between ordinary income from

the business and the depletion of capital used in the business."

The same history disposes of the contention of the Government (Br. 19, note) that the decision in the *Sanford & Brooks Co. case* in some way overruled or disapproved *Bowers vs. Kerbaugh-Empire Co., supra,* which has since been cited for the very point on which it is contended that it was overruled.

United States vs. Kirby Lumber Co. (1931), 284 U. S. 1, 3, 52 Sup. Ct. 4, 76 L. Ed. 131;

Helvering vs. American Chicle Co. (1934), 291 U. S. 426, 54 Sup. Ct. 460, 78 L. Ed. 891.

The Government confesses inability to perceive any "logical basis or practical reason" for the distinction, as to single-year accounting, between operating expenses and income on the one hand, and capital investment and return on the other (Br. 18). If the Sixteenth Amendment had conferred upon Congress the power to tax capital, or the restoration of capital, without apportionment, there would indeed be no basis or reason for any such distinction. But once it is conceded, as it must be conceded, that there is no power to tax the mere return of invested capital, unaccompanied by any gain, it follows that such a return can no more be taxed through the device of single-year, or single-month, accounting, than by a statute declaring in so many words a levy upon the capital thus restored. This we believe to be the plain significance of the distinction made in *Burnet vs. Sanford & Brooks Co., supra.*

Nor is there any indication that Congress has displayed any intention of taxing such a capital return as this. The Government recognizes (Br. 12) that the repayments to the taxpayers in 1939 were in exchange for the surrender of a right of rescission, which was itself a property interest, and which was neither sold nor extinguished in the prior years.

The argument (Br. 10-13) that upon the sale or disposition of such an interest the statute requires that adjustment be made for past deductions which have not in fact restored capital, turns upon the definition of "Adjusted Basis" in Section 113 (b) (1) (set forth in the Government's Brief, at pages 11, 36), which is

> "(1) . . . *Proper* adjustment in respect of the property shall in all cases be made—
>
> (A) For expenditures, receipts, *losses,* or other items, *properly chargeable to capital account,* including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years." (Italics supplied.)

In the light of the italicized words, the Government's argument from the statute merely begs the question. Whether the paper loss deducted in the prior year, which did not in fact restore capital, is "properly chargeable to capital account" is what we now seek to determine. It is not to be presumed that Congress had any such intention.

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government and in favor of the citizen."
>
> *Gould vs. Gould* (1917), 245 U. S. 151, 153, 38 Sup. Ct. 53, 62 L. Ed. 211.

And in any case, it is of course fundamental that Congress, by enacting any statutory provision whatever, cannot confer upon itself the power to tax a return of capital if that power does not otherwise exist under the Sixteenth Amendment.

2. The contention that the opportunity afforded to deduct the loss upon sale of the stock is the equivalent of a restoration of capital.

When the taxpayers sold their stock of the National City Bank in the prior years, they were permitted by the statute then in force to deduct the full amount of the difference between purchase price and resale price, even though, as events subsquently proved, they had still a right of rescission of the purchase which had value. If that deduction had resulted in the allocation of otherwise tax-free income to restoration of the capital loss, it is conceded that subsequent recovery would have been income, as in *Griffiths vs. Commissioner* (1939), 308 U. S. 355, 60 Sup. Ct. 277, 84 L. Ed. 319. In fact, however, no such restoration occurred, for there was no tax-free income to be allocated in the years in question. In truth, in economic reality and in practical effect, the deduction was a paper one only. The loss was "deducted" from a residue of nothing.

It is contended, however (Br. 9-16), that the mere affording of an opportunity to make this paper deduction of a loss from zero restored the taxpayer's invested capital, so that a later actual restoration becomes gain. "The right to a deduction for loss of capital is treated as the equivalent, for tax purposes, of a prior capital return in computing the gain realized upon subsequent disposition of the remaining property interest" (Br. 11-12). Before the Board of Tax Appeals the Government assumed (R. 110) that where, in the case of the taxpayer, John V. Dobson, the deduction was not even listed on paper, a subsequent recovery was not taxable as income. As the implications of this concession become apparent, it is now withdrawn, and the Government contends (Br. 16, note) that the subsequent recovery is taxable even though the deduction never was listed at all. Bald-

ly stated, the theoretical "opportunity" to claim a deduction, even if there were no income from which to deduct it, is declared to be a return of the investment, beyond which any actual return is gain. We respectfully suggest that the only name for this is bare-faced fiction.

What if, in the case at bar, the stock purchased had been resold on December 31, 1930, and on January 1, 1931, the taxpayer had made claim of fraud, and on that day had received repayment of a part of his purchase money, leaving him still with a loss? It must follow from the Government's contentions that the naked possibility of claiming a deduction for the year 1930, even with no income from which to deduct it, restores the invested capital in its entirety, and transforms the loss into gain. We do not believe that either Congress or the Treasury can confer upon itself, by such a transparent accounting device, the power to tax as gain what is not gain in fact.

The Government professes to find authority for its position in *United States vs. Ludey* (1927), 274 U. S. 295, 47 Sup. Ct. 608, 71 L. Ed. 1054. That case arose out of the sale of oil land, oil leases, and mining equipment. In determining gain or loss on the sale, it was held that there must be subtracted from original cost the full allowable depreciation and depletion of the property over a period of years, even though the taxpayer had claimed only part of it in his income tax returns. Depreciation and depletion had in fact occurred; it was not disputed that the assets had in fact been wasted.[1] The question before the Court was one of how the

[1]The statute involved permitted deduction only where there was in fact depreciation or depletion. It is set out in the case, at page 298, as follows:

"Fourth. Losses actually sustained during the year, incurred in his business or trade. * * *

"Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade;

"Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production. * * * (b) in the case of mines a reasonable allowance for depletion thereof. * * *"

amount of it should be determined. The Bureau had estimated an actual depletion and depreciation in excess of the aggregate deductions allowable under the statute, and there was no dispute of fact concerning the correctness of these estimates.[2] The conclusion was that the gain or loss realized on the sale of the property was not dependent upon the taxpayer's prior income tax returns, which might be rectified if they were in error.[3] Rather the amount to be subtracted from original cost as a basis for determining gain or loss must be, subject to the limits of the statutory aggregate,[4] the depreciation and depletion in fact sustained.

With respect to the *Ludey case,* it must be pointed out, first, that it decided that gain or loss in a capital transaction is to be determined on the basis of the completed transaction, and that the income tax returns for any individual year are not controlling. That is of course what the taxpayers are contending in the case at bar. Far from sustain-

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2"For the purpose of determining the cost of the properties sold in 1917 the Commissioner deducted from the original cost $10,465.16 on account of depreciation of the equipment through wear and tear, and $32,258.81 on account of depletion of the reserves through the taking out of oil by the plaintiff, after March 1, 1913. There was no dispute of fact concerning the correctness of the estimates upon which these deductions were made. The finding of the depletion was in accordance with the method of computation employed by the Bureau of Internal Revenue; and there was no objection specifically to the method of computation. * * * The finding of the depreciation was, likewise, in accordance with the method of computation employed by the Bureau; and there was no objection to the method of computation." **United States vs. Ludey, supra,** at page 297.

3"The aggregate for depreciation and depletion claimed by Ludey in the income tax returns for the years 1913, 1914, 1915 and 1916, and allowed, was only $5,156. He insists that more cannot be deducted from the original cost in making the return for 1917. The contention is unsound. The amount of the gain on the sale is not dependent on the amount claimed in earlier years. If in any year he has failed to claim, or has been denied, the amount to which he was entitled, rectification of the error must be sought through a review of the action of the Bureau for that year. He cannot choose the year in which he will take a reduction." **United States vs. Ludey, supra,** at page 304.

4"On the other hand, we cannot accept the Government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years." (Emphasis supplied.) **United States vs. Ludey, supra,** at page 304.

ing any theory of final and conclusive accounting in a single year (Br. 12-13), the opinion expressly denies it: "The amount of the gain on the sale is not dependent on the amount claimed in earlier years."[5] Second, the case involved the straight-line method of depletion and depreciation, which necessarily requires that deductions be taken on the basis of a more or less arbitrary estimate at a uniform rate each year, so that, once embarked upon the process, the taxpayer "cannot choose the year in which he will take a reduction." The invested capital is recovered ratably over a group of years, rather than on the basis of the events of a single year; and this is not true of other forms of capital recovery. Third, the depletion and depreciation had in fact occurred. Over the entire period oil had been extracted and sold, and equipment had been used and consumed, so that it was in fact depleted and depreciated property which was sold. The Court recognized economic fact. The error in theory was that of the taxpayer who had failed to claim the full deductions to which he was entitled by reason of this return of his capital investment.

> "The theory underlying this allowance for depreciation is that *by using up the plant, a gradual sale is made of it.* The depreciation charged is the measure of the cost of the part which has been sold." (Italics supplied.)
>
> *United States vs. Ludey,* at page 301.

That error, the Court found, might still be rectified by correction of earlier income tax returns. In the case at bar, the economic fact is that the taxpayers have had no gain, but a loss; and if there is error in theory, it is that of the Government in maintaining that the capital has been restored by a fiction.

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[5]United States vs. Ludey, supra, at page 304.

3. The Revenue Act of 1942, Section 116.

The Government contends (Br. 23-26) that the legislative history of Section 116 of the Revenue Act of 1942 indicates that Congress regarded reimbursement of items deducted without tax benefit in prior years as taxable income. It is of course clear that if such reimbursement was in fact a return of capital, which Congress has no power to tax, its belief in the matter cannot alter the situation. However, there is no clear indication that Congress entertained any such belief.

Prior to the enactment of the new Section, the Bureau had twice reversed its position with reference to reimbursement of bad debts previously deducted without tax benefit. Prior to 1937 it regarded such reimbursement as taxable income. In 1937, in G. C. M. 18525, 1937-1 C. B. 82, reaffirmed in G. C. M. 20854, 1939-1 C. B. 102, it concluded that it was not. In 1940, in G. C. M. 22163, 1940-a C. B. 76, it reverted to the opinion that such reimbursement was income, justifying its conclusion in part with the assertion that bad debts are operating expenses within the rule of *Burnet vs. Sanford & Brooks Co., supra.*[6] The same opinion drew the same conclusion as to prior deduction of taxes, and withdrew ac-

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[6] "Under the principle of the Supreme Court's decision in the Sanford & Brooks Co. case, supra, items of expense incurred in carrying on a trade or business do not represent capital investment, the cost of which, if converted, must first be restored before there is a capital gain taxable as income. Bad debts charged off in any business are deductible under a specific provision of the Revenue Acts rather than as ordinary and necessary business expenses. They are, nevertheless, under well-established accounting practices, recognized as operating expenses of the business deductible as such in arriving at the net operating gain or loss for the periods involved. See **Finney, Principles of Accounting,** 1934 Edition, Volume 1, page 37, and **Kester, Principles of Accounting,** Fourth Edition, pages 46, 116, and 554. Consequently the amount represented by debts which become worthless and are charged off in the carrying on of a trade or business is not to be considered as an investment of capital which must first be returned in full before taxable income is derived. Under this principle, amounts recovered in any taxable year upon debts previously charged off and allowed as a deduction should be treated as taxable income regardless of whether the prior allowance of the deduction resulted in a tax benefit to the taxpayer." G. C. M. 22163, 1940-2 C. B. 76, 79.

quiescence in decisions of the Board of Tax Appeals to the contrary. The Bureau took no express position with respect to the deduction of other types of losses. Meanwhile the Board of Tax Appeals, which had followed the first change of position, refused to follow the second one, and continued to hold that the reimbursement was not income unless there had been tax benefit (Br. 23).

In this state of affairs there was certainly "no such history of consistent and well settled Treasury regulations and interpretations adopted by Congressional acquiescence and re-enactment as will write into the Statute a rule to govern this case."

> *Philadelphia National Bank vs. Rothensies* (D. C. Pa., 1942), 43 F. Supp. 923, 925.

Rather the reasonable conclusion is that Congress disapproved the policy declared by the Bureau with respect to bad debts and taxes, and intended to overrule it and adopt the tax benefit position of the Board of Tax Appeals; and that the new Act refers only to bad debts, taxes and delinquency amounts for the reason that G. C. M. 22163 did not go beyond those items.

4. Administrative difficulties.

The Government's Brief makes much of administrative difficulties in the application of the "tax benefit" principle. It then proceeds to quote (Br. 24, note) from the Statement of Mr. Randolph Paul before the Ways and Means Committee of the House of Representatives, as follows:

> "It is believed that the hardships can be removed and the administrative difficulties kept to a minimum by excluding from income amounts received in payment of the debt to the extent that the deduction on account of the debt in the prior year did not produce a tax benefit. The troublesome question whether a benefit resulted

should be determinated pursuant to regulations prescribed by the Commissioner with the approval of the Secretary. It is also suggested that this treatment be extended to refunds of taxes previously deducted."

Administrative difficulties cannot transform loss in fact into gain in fact, or restitution of capital into income. But as to such minor difficulties as may arise, the Government has answered itself. There is no problem or difficulty suggested in the Brief (26-30) which will not in fact arise under the new provisions of the Revenue Act of 1942—including even the question whether a bad debt, a tax, or a delinquency amount shall be deemed to be the last deduction taken when all three were deducted in the same year. The representative of the Bureau has expressed to Congress entire confidence in the ability of the Bureau to meet these difficulties by appropriate regulations. It is not for the taxpayers to refuse to share that confidence. We have no more fear of an administrative breakdown as a result of a decision of this Court in our favor, than as a result of the enactment of the Revenue Act of 1942.

However that may be, the difficulties do not arise in the cases at bar. It is not disputed that the other deductions which reduced income to a net loss in 1930 and 1931 were properly taken, and that they were sufficient to leave no tax-free income available to restore the capital invested in stock of the National City Bank. Only one deduction for each year for each taxpayer is in question now. Unless that deduction resulted in an allocation of otherwise tax-free income to the restoration of capital, the capital investment has not been restored. The method of the Revenue Act of 1942 is to regard the deduction in question as the last one taken. That method is sufficient for this case. If, instead, it were to be regarded, for example, as the first taken, the only effect would be to allocate tax-free income to the restoration of this capital in-

vestment at the expense of some other legitimate deduction to which it might have been allocated instead. One uncompensated loss would be substituted for another, and the net loss on the year would remain the same. Such juggling of figures arrives nowhere. The reality is, as any business man would recognize, that the taxpayers were unable to restore their capital out of income in 1930 and 1931 because they had no income left.

Respectfully submitted,

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